Investment Insight: Social Housing

March 2013

Defined benefit: **Yes**
Defined contribution: **Of interest**

Welcome to the first edition of the NAPF's new **Investment Insight** series! Our Investment Insights are designed to be a one stop shop for our fund members, offering a quick insight into individual asset classes. This first edition focusses on Social Housing as an asset class.

What is Social Housing?

Social housing refers to the provision of affordable accommodation to people on low incomes. This is provided mainly by registered social landlords (RSLs or housing associations) and local councils. Today in the UK we have 1,700 housing associations covering around 2.5 million homes. There is also an estimated unsatisfied demand for a further 2 million homes.[1] The Government supports social housing through a system of grants and housing allowances, and RSLs must comply with the Homes and Communities Agency (HCA) rules and with standards of corporate governance as set out in the Companies Act. In 2012, housing associations raised almost £4 billion in the capital markets, four times the previous annual record. At the same time, our members are getting increasingly interested in social housing as a form of investment, attracted by the higher yields when compared to the current low yields of inflation linked gilts. As we know, there is no such thing as a free lunch and here we look at some of the merits and the drawbacks and how pension schemes can access social housing as an asset class.

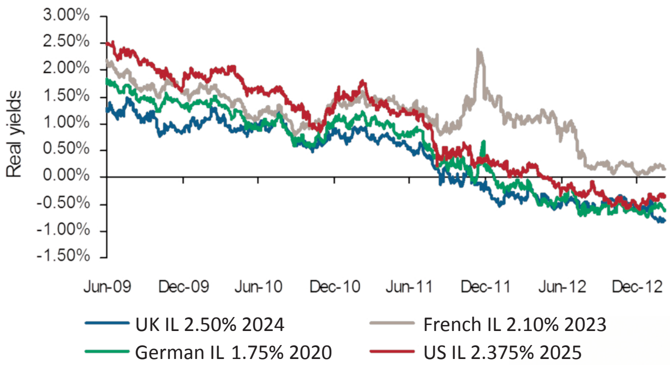
1 Source: Barclays, Social Housing Q2, 2011

NAPF
Securing the future of pensions

What's the USP?

The real attraction of this asset class is that it has liability-matching properties *and* the potential for investment returns much higher than those currently available on inflation linked gilts. Here, and elsewhere in the world, government inflation linked bond yields are negative or approaching negative real yields (see chart below).

Global real yields



Let's get down to business - what about the risk and returns?

Moody's publicly rate 26 housing associations in the UK (see a selection of names in Table 1). The ratings range between Aa2 to A1 suggesting that in the 'unlikely event of a housing association facing acute liquidity stress, the UK government will very likely provide extraordinary support'. The rating also reflects the fact that the social housing stock itself serves as collateral in the event of a default as the houses would be sold and the proceeds would go to the creditors. **The majority of the association's rental income comes from local government** with very robust rent collection rates. Therefore, investing in social housing ticks the boxes in terms of relatively high credit worthiness.

Table 1. Moody's Rating	
Family Mosaic	Aa2
Peabody Trust	Aa2
Radian Group	Aa2
AmicusHorizon	Aa3
Notting Hill Housing Group	Aa3
Together Housing Group	Aa3
Genesis Housing Association	A1
B3 Living	A1

In term of returns, when compared to inflation linked gilts, social housing bonds could potentially return 1.5% to 2.5% extra return for investors[2]. As housing associations can face balance sheet constraints in terms of how much debt they can issue they may choose to use other ways of accessing additional financing – such as development partnerships (see next page). Returns can be significantly higher for investments via development partnerships and sale and leaseback agreements – although these come with additional risk.

So what's new?

Historically, medium and smaller housing associations went to the banks for their borrowing requirements (usually for a term of between 30 and 50 years) or issued bonds via The Housing Finance Corporation (THFC). Only the largest associations can borrow directly in public bond markets. However following the financial crisis and the deployment of Basel 3 capital requirements, banks have become very reluctant to hold long term illiquid assets on their balance sheet and investor appetite has also dwindled as clients have sought refuge in AAA sovereign bonds. These sea changes occurred at the same time as the Government's austerity measures led to a cut of almost 50% in grants to the sector. It is now estimated that housing associations will need to borrow around £15 billion to fund planned regeneration and maintenance projects between now and 2015.[3]

If I've got a DB scheme, is it a good match?

The great news is that, since 2005, the Government has set rent increases for housing associations to be RPI plus 0.5% therefore linking the rental stream to inflation. Given the long term nature of social housing borrowing, social housing investment can therefore be compared to investing in long-dated inflation linked assets as associations can make interest payments (coupons) that rise in line with inflation because their revenues, from tenants' rents, do exactly the same. Additionally, as most pension schemes have their liability increases capped at say RPI or 5%, social housing bonds can also be designed with a matching inflation cap, making them an even more attractive source of funding for RSLs. However, housing associations (and investors) face a certain degree of regulatory risk as the Government may choose to change the method for indexing rents to inflation in the future. If, for example, the indexation of rental income was changed to CPI – or some other measure – housing association locked into interest payments that are indexed to RPI could face mis-matches between these payments and their rental income.

2 Source: M&G Investments

3 Source: Redington

What about DC?

We have spoken to a number of our DC members regarding accessing social housing for their schemes. The consensus currently is that there is insufficient liquidity in this market.

What are our pension fund members doing?

There is increasing interest in this asset class although only a few members have dipped their toes into the social housing waters to date. To quote a few:

> "At DMGT we have begun investing in social housing debt for our pension schemes as we believe the returns are a good match for our liabilities. It is an index linked bond proxy, with a much better yield, for not much additional risk and manageable illiquidity."
>
> ***Mike Weston***
> *CIO, DMGT Pensions.*

> "Inflation linked returns, a high level of security and cashflows which are largely underpinned by Government-it must be worth a second look."
>
> ***Sue Timbrell***
> *Director, LawDeb Pension Trustees.*

Sounds encouraging, how do we get access to it?

Pension funds are looking at a number of ways of accessing social housing. The main ways are as follows:

- **Buying inflation-linked social housing bonds** via a scheme's corporate bond portfolio is possible but these bonds are not readily bought and sold. Given this lack of liquidity, in recent years a few asset managers have launched social housing fund vehicles for pension schemes to invest in which give exposure to a portfolio of different social housing bonds diversified across different RSL's, in different parts of the UK.

- **Development partnership** – these represent equity investments in social housing and are usually used by housing associations that have reached their maximum level of balance sheet leverage. This way of access carries higher risks (in particular the risks associated with getting involved in the development stages of a building project) than either buying social housing bonds or a sale and leaseback agreement, but it also offers higher expected returns.

- **Sale and leaseback agreement**. This consists of buying a number of existing properties and leasing them back to the housing association for a period of 30 to 50 years. Depending on the agreement, the property ownership may revert back to the association, in which case the pension scheme investor would receive the amortisation of the capital value (ie income stream) over the term of the lease.

Investors should also be aware that the risk/return profile of a particular investment depends on a number of different factors – although this is more important for development partnerships or sale and leaseback agreements than social housing bonds (as these enjoy seniority in the capital structure). These factors include: the precise type of housing being built, the amount of development risk the investor is taking on, the size of the project and (as always with property) the location of the development.

What's the catch?

Welfare reforms and the introduction of 'universal credit' could increase the risk that tenants do not pay their rents. Asset managers investing in social housing have indicated that they do not expect this to have a major impact on housing associations' credit quality as mechanisms for managing the increased risk of arrears are being put in place. However, additional austerity measures could lead to further cuts in Government grants. This could lead to credit deterioration.

A further consideration is the lack of liquidity and depth of providers in this new investment class.

So summing it up…

Pros

- Meets the need for inflation-linked cashflows
- Higher yield/return compared to inflation-linked gilts
- Relatively high credit rating & heavily regulated
- Could be seen as a socially-responsible investment

Cons

- Limited market accessibility as investment vehicles are in their infancy
- Liquidity is poor therefore better suited to buy and hold strategies
- Transparency regarding valuations limited – tricky to provide marked to market pricing

If you have feedback on this edition of Investment Insight, or would like to speak to us about forthcoming editions, please contact our new investment specialist: **Helen.Roberts@napf.co.uk.**